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BEFORE THE
SUBCOMMITTEE ON COMMERICAL AND ADMINISTRATIVE LAW
COMMITTEE ON THE JUDICIARY
U.S. HOUSE OF REPRESENTATIVES

REGARDING
H.R. 1369, A BILL PROHIBITING DISCRIMINATORY TAX TREATMENT OF NATURAL GAS PIPELINE PROPERTY

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Introduction

We are confronted today with a very specific question: should states be allowed to tax the property of interstate natural gas pipelines differently than other forms of property? To ensure that we do not get lost in the details of such a specific question, it is useful to ground our analysis in fundamental economic principles.

Economists are infamous for their propensity to see all sides of an issue and never reach a definitive conclusion—President Harry Truman reportedly demanded a one-handed economist because economists were always telling him, "On the one hand... on the other hand...."—but on some fundamental ideas they are in absolute agreement. Among these is the principle that taxes distort behavior. The size of the distortion may vary, but it exists nonetheless. In the case of gas pipelines, the relative immobility of the capital may seem to make the distortionary effect small, but over the long run, high taxes will discourage investment in pipelines. This in turn will increase the price of gas. As important as natural gas is to our economy, we cannot afford to burden our interstate pipelines with high taxes and risk weakening the pipeline infrastructure.

If this legislation HR 1369 to prevent certain discriminatory taxation of natural gas pipeline property reduces taxes paid by the pipeline industry and reduces the uncertainty faced by pipeline owners then it could go a long way toward promoting new infrastructure investments. This would increase competition between pipeline operators and lead to low energy prices in the longer run.

1. The Economics of Taxation

Economics tells us that people make decisions by comparing marginal costs and marginal benefits. A consumer will buy an apple if the enjoyment she'll get from it is greater than its price. An apple grower will plant another tree if he'll be able to sell its apples for more than it costs him to take care of the additional tree.

When the government imposes taxes, it distorts these decisions. A tax raises the marginal cost of a product or activity, thereby discouraging people from choosing it. The consumer may

find that the apple is no longer worth the price she would have to pay for it—she may buy an orange instead. The apple grower may determine that he will not be able to recoup the cost of taking care of an additional tree—so he won't plant it. By choosing what and how much to tax, the government influences people's behavior; in effect, the government interferes with market decisions about the allocation of resources in the economy.

In a free market, individuals direct resources to their most highly valued uses. Consumers and producers spend their money on the products and activities that will give them the most "bang for their buck." Taxing these things pushes people away from the most highly valued products and activities and towards the next-best ones. In this way, the tax-induced distortions in behavior tend to make the market inefficient.

2. The Hold Up Problem

However, some taxes distort less than others because they cause smaller changes in behavior. A tax on goods for which the supply is unresponsive to tax rates would induce fewer distortions than one on goods for which supply is highly responsive to tax rates. For instance, a tax on medicine or the air we breathe would lead to few distortions, while a tax on movie tickets or restaurants would lead to much distortion because there are more substitutes. Sick people often find themselves in a situation where they must get a given drug—at any cost—and we cannot easily switch to breathing a different gas, but we can easily find new sources of entertainment.

Natural gas pipelines are more similar to medicine and oxygen: by their nature, they are very unresponsive to tax treatment. Investment in a pipeline is irreversible. Once pipelines are built, their owners cannot easily move their operations to other states if they are unhappy with the tax rates in a given state. The problem is exacerbated for interstate pipelines—rerouting a pipeline to avoid an entire state would be exceedingly difficult.

As economists Benjamin Klein, Robert G. Crawford, and Armen A. Alchian explained in an influential paper, a party that contracts to make a relationship-specific or irreversible investment becomes susceptible to a "hold-up problem."[1] Say party A makes a specialized investment to fulfill a contract with party B. Once the investment has been made, A is stuck with

the deal; he invested in such a specialized asset that it has little value in any use other than what he contracted with B. Knowing this, B can opportunistically renegotiate a lower payment to A.

Although Klein, Crawford, and Alchian focused on how firms vertically integrate or sign long-term contracts to avoid hold-up after investment occurs, an analogy can be drawn to pipelines. Once the natural gas pipelines have already been built across several states, the pipeline owner is locked in and the bargaining power is in the hands of the state. The state has the power to demand a larger share of the profits or to impose some form of discriminatory tax, since the pipeline owner is now deeply invested in the state. In theory, the state could even demand all of the profits, because the pipeline owner's alternative is to lose the investment entirely.

Their lack of mobility means that pipeline owners cannot easily react to an increase in their tax burden. To put it bluntly, the state can effectively hold the pipeline investments hostage and extract high tax payments in return. Considering that a state's objective is to maximize its tax revenues, imposing discriminatory taxes on natural gas pipelines and other immobile goods makes economic sense.

In addition, States legislators will try to impose taxes at the lowest cost for themselves. The best way to do that is to impose higher taxes on out-of-state companies rather than on intra-state enterprises. This approach exports the costs associated with higher taxation to outside jurisdictions, while allowing legislators to side step the political repercussions of taxing their own constituents. Given the interstate nature of pipelines, they are a prime target for this type of state taxation.

3. Discriminatory Treatment of Natural Gas Pipeline Property

In practice, this is exactly what states are doing. As explained in the previous section, pipeline property, by its very nature, is a target of choice for state legislators wanting to maximize tax revenues. Under the current federal law, there is no provision to prohibit discriminatory treatment of property belonging to interstate natural gas pipeline companies. As a result, states subject capital that cannot move—the pipelines—to a higher tax than other forms of capital.

According to experts in the industry, 17 states have tax laws that discriminate against natural gas pipelines. They do this in a variety of ways. For instance, some states distinguish pipelines from other businesses for the purpose of imposing a higher property tax rate on interstate companies. Other states manipulate their treatment of personal and real pipeline property, excluding personal property from taxation generally but including pipeline personal property. Still other states assess pipeline property at a different ratio than other commercial property. Industry experts estimate that the cumulative effect of these discriminatory tax policies is to increase the property tax bills of natural gas pipeline companies by more than 40 percent: in 2004, natural gas pipeline companies paid $445 million in property tax, while they would have paid only $256 million if state tax laws treated pipeline companies the same as they treat other businesses.

In the past, Congress has passed legislation prohibiting discriminatory treatment of property belonging to other industries operating in interstate commerce, such as rail, motor carrier, and air carrier transportation. These laws prohibit discriminatory tax treatment similar to what the interstate natural gas pipeline industry currently faces. In 1976, Congress passed the Railroad Revitalization and Regulatory Reform Act (later repealed by ICC Termination Act of 1995). A portion of the act relevant to the topic at hand provided that states may tax railroad property at a rate not exceeding the rate applicable to other property in the State. Also a state may not assess rail transportation property (49 U.S.C. § 11501), motor carrier transportation property (49 U.S.C. § 14502), or air carrier transportation property (49 U.S.C. § 40116) at a value that has a higher ratio to the true market value of the property than that of other commercial and industrial property in the same jurisdiction.

In other words, States can no longer discriminate against the commercial property of these protected interstate transporters as compared to how that State treats its own intrastate commercial and industrial property.

It should be noted that these policies were enacted over the states' strenuous objections.[2] States never find it in their short term interest to lose the power to extract a significant rent from captive capital.

Finally, the discrimination does not stop there. Under current law, pipelines also face a larger burden when it comes to challenging state tax discrimination. As it stands, interstate natural gas pipeline companies have no recourse in the federal court system to seek relief from

discriminatory tax practices with respect to property assessments. Unlike other major interstate enterprises, such as rail, motor, and air carriers, interstate natural gas pipeline companies must typically pursue relief from discriminatory tax practices through state level appeal processes. This is an extremely difficult burden to carry.

4. The not so hidden cost of discriminatory taxes

On second look, however, tax discrimination remains a very poor calculation on the part of the state. Although it would be exceedingly costly for the companies to reroute their pipelines, taxation will alter their behavior in other ways. The higher cost of owning a pipeline means they will invest less in new pipelines and spend less on maintaining their existing equipment.

Furthermore, as Nobel Prize laureates Finn E. Kydland and Edward C. Prescott have demonstrated, if companies expect that states may raise their taxes in the future, they will invest less today.[3] As explained earlier, pipeline companies, unlike companies in other interstate industries, are not protected by federal guarantees against tax discrimination. The companies may reasonably fear that states will raise their taxes, and this uncertainty dampens their motivation to invest today.

Moreover, the work of MacDonald and Siegel suggests that when investments are irreversible, uncertainty concerning possible future tax changes may have massive disincentive effects on future investment.[4] Firms only chose to "nail down" large capital projects when they have confidence concerning the likely future paths of the key economic variables affecting their profitability. This suggests that a policy that reduces uncertainty surrounding future tax variables at the state level may have profound effects on investment.

The lack of new investments in the pipeline industry along with the lack of maintenance investment for already existing pipelines could have very costly consequences. According to a Republican Policy Committee paper published in November 2004, U.S. industry overall depends on natural gas for 27 percent of its primary energy consumption. Because of such a strong reliance on natural gas, U.S. consumption continues to rise despite escalating prices. The United States is expected to consume nearly 30 trillion cubic feet (Tcf) of natural gas per year by 2020—a 38 percent increase over current consumption levels.

To meet this strong demand, the industry estimates that $61 billion in natural gas infrastructure investment will be needed over the next 15 years. This includes investment in pipelines, storage facilities, and liquefied natural gas terminals. However, as mentioned earlier state discriminatory taxation of natural gas pipeline property discourages the pipeline industry from investing in infrastructure.

What happens if no new natural gas infrastructure is built? Quite simply, delays in pipeline and natural gas terminal construction will reduce the amount of natural gas available to consumers and thereby increase the price that they must pay. This likely will cause further job losses in industrial sectors that depend on affordable supplies of natural gas, such as chemical and fertilizer manufacturing. Because an increasing amount of electricity is generated by natural gas, electricity prices will be higher for virtually all consumers.

The Interstate Natural Gas Association of America Foundation completed an economic analysis that quantifies some of the consumer costs associated with delays in constructing new pipeline and natural gas import capacity.[5] The study published in July 2005 found startling results: a two-year delay in building natural gas infrastructure (both pipelines and LNG terminals) would cost U.S. natural gas consumers in excess of $200 billion by 2020.[6] The state of California, alone, would experience increased natural gas costs of almost $30 billion over that period. And, of course, should the end result be that certain facilities are never constructed, the economic effect would be even more severe.

The bottom line is that natural gas infrastructure delays and cancellations have consequences. Every consumer will pay higher prices for natural gas, electricity and the goods produced using natural gas if we do not act to ensure that natural gas industry has the appropriate incentives to increase adequate pipeline capacity in time to keep supplies affordable.

Of course other current government policies discourage the market from investing in infrastructure. According to the RSC, regulatory impediments to investment include jurisdictional confusion, which delays infrastructure construction; and "open access" and rate regulations, which distort rates of return on investment along to the tax impediments already mentioned.[7] Other tax issues include too-lengthy depreciation periods. Congress should allow the market to work. It should clarify administrative jurisdiction; it should terminate open access requirements and introduce market pricing of natural gas infrastructure services; and it should

reduce depreciation periods or permit immediate expensing for tax purposes on capital investment.

Conclusion

In this area of higher energy prices exacerbated by hurricanes Katrina and Rita, it is all the more important to find a way to decrease energy prices. An important component of this bill is the provision of relief through the federal court system. It provides a statutory grant of jurisdiction which affords interstate natural gas pipeline companies the same relief avenues currently available to other major interstate commerce industries. By giving a judicial avenue to pipelines to contest their tax treatment, it reduces significantly the hold up problem they faced for years and reduces their uncertainty.

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[1] Klein, Benjamin, Robert G. Crawford, and Armen A. Alchian (1978). "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," *Journal of Law and Economics* 21(2): 297-326.
[2] Michael S. Greve (2002), "Business, The States And Federalism's Political Economy," Harvard Journal of law and Public Policy, Summer, p. 895-929.
[3] Kydland, Finn E. and Edward C. Prescott (1977). "Rules Rather than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy* 85(3): 473-492.
[4] Robert MacDonald abd Daniel Siegel (1986), "The Value of Waiting to Invest," Quarterly Journal of Economics, Vol. 101, N. 4, November, p. 707-728.
[5] For more information see http://www.ingaa.org/Documents/Foundation%20Studies/F-2005-01%20(Avoiding%20and%20Resolving%20Conflicts).pdf
[6] Ibid, p. 1.
[7] Republican Study Committee (2004), " How Congress should help meet the Nation's Natural gas supply needs," November 16.